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CAPITALIZATION OF CORPORATIONS—DISCUSSION.

F. J. SWAYZE: We have not had in New Jersey the difficulties which Professor Bullock has spoken of as arising under the Massachusetts statute. We have been, perhaps, too liberal in our laws, allowing corporations to issue stock for property, when it is often done at a gross overvaluation; but the statute provides, and the courts have always, where a proper case has been presented, insisted that the stock should represent money or money's worth. The great difficulty presented is not with the legal principles involved, but with the proof, and it is, generally at least in a case of any importance and always after the lapse of time, exceedingly difficult to prove the fact of overcapitalization. I was myself counsel in the chief case in this state in which the promoters of a corporation were made to pay a considerable sum to a receiver on account of their stock liability, but the litigation was a very long and expensive one, and would not be open to the ordinary litigant. The consequence has been that a feeling has grown up among many thoughtful men that the true solution of the difficulty is not to put corporations in a strait-jacket, for, when they require money they must, as Professor Bullock's paper has shown, accede to the terms upon which lenders are willing to advance the money. Some of us have come to think that the true solution is that suggested by Governor Stokes in his last annual message,—to allow corporations to issue stock that shall represent what the fact really is, the fractional share of the assets of the corporation to which the particular stockholder is entitled, and specify no par value what-

ever. This would leave the stock to find its value in the market, as in fact it does under our present system, and would avoid the difficulty of imprinting upon the stock what may be false. A difficulty might, of course, arise, if this method should be adopted, when it comes to determine what are reasonable rates, but I don't know that this difficulty is any greater than that which is presented by the present situation. The truth is, I think, that the determination of rates bears a very remote relation to the capitalization of the corporation. It depends upon a great many considerations, and is largely a matter of historical growth, or of custom, a reasonable rate being that which people are accustomed to pay, or what is deemed to be fair. And in the case of railroad rates, where the question is so extremely complicated that a rate which might produce no returns, and not even the bare cost of doing the business, may, in special instances, be a perfectly fair rate, while in instances of other commodities a rate which bears a very large proportion to the cost of the service, and the returns from which are lucrative to the corporation, may still be deemed reasonable by those who have the bills to pay. I am quite skeptical as to the ability to determine by any mathematical formula the reasonableness of any rate when the question is at all complicated, as it necessarily is in the case of railway rates. To my mind, such work as can be done by the public authorities must largely be done in the direction of collective bargaining. The case may possibly be different with gas companies and electric light companies, or where the commodities supplied are few in number and the place in which the company operates is comparatively narrow, but even in such cases it would be difficult to adopt a mathematical formula based upon a percentage of the capital invested.

We have recently had occasion in New Jersey to pass upon the reasonableness of charges for water, and one of the questions which we had to consider was the reasonableness of expenditures made, not for the immediate needs of the service, but with a view to the probable future expansion.

If a mathematical formula is not to be adopted, and if, as the decisions of the courts heretofore seem to indicate, considerations such as I have suggested are to apply, it becomes of little consequence whether we issue stock with a par value, or whether we merely indicate that a certificate represents a fractional share of the corporation.

MILO R. MALTBIE: Although Professor Bullock does not definitely state that he would favor a repeal of the provisions of the Massachusetts law making it impossible to issue securities below par, he indicates that the plan is at least worthy of discussion. In my opinion, it would be exceedingly unfortunate for Massachusetts to take this backward step, and I am surprised to hear that anyone seriously recommends it, as this is one of the provisions which seems to be generally approved not only by the public but by Massachusetts corporations themselves. It has been upon the statute books for many years, and is a principal reason why overcapitalization in the Bay State has not been so rampant as elsewhere. It is interesting to contrast the street railway situation in New York with that of Boston or any other Massachusetts city. It is beyond question that the statutory limitation has prevented many of the evils from which we have suffered and are now suffering in New York.

Furthermore, it has not prevented the development of private corporations. The gas, electric light, and street railway companies of Massachusetts are as progressive

as those of any other state of the Union. Their lines have been extended in a way surpassed by no state, and in the main the corporations are in a healthy condition and prosperous.

The difficulty, apparently, which seems to affect Professor Bullock so greatly is that certain corporations found it exceedingly difficult to issue securities at par during the past year and a half. But what corporation did not find it difficult to do so? The universal trouble was due not to the law but to the commercial conditions and to the financial panic from which we are just emerging. It is possible that if there had been no restriction upon the price at which securities could be sold, it would have been easier for corporations to dispose of them, but that is not the only solution, and it would seem exceedingly unwise to recommend the general adoption of a plan which is suited to abnormal conditions only and which is unnecessary except perhaps occasionally.

However, if a corporation finds it difficult to issue its stock at par under normal conditions, why is it necessary to allow it to sell below par? By so doing the earning capacity of the company is not affected beyond the amount of money *actually* invested; that is, the financial status of a corporation is determined not by the securities which it issues but by the amount of money actually invested and the earning ability of the investment. If stock of a par value of $1,000,000 is issued for $500,000 cash, it does not mean that the company will earn a profit upon $1,000,000 any more than it does if the par value of the stock had been made $500,000 and it had been disposed of at par. Furthermore, the stockholders will not receive a greater amount upon their *investment.* They will receive the same in any case, and the fact that the par value of their stock is twice the investment will not of itself make profits.

If it is necessary to give certain stockholders a preference over others, it does not follow that the only remedy is to allow stock issued to these holders to be sold below par. Preferred stock of various classes may be issued, and there are various other ways of reaching the same result; one is not forced to adopt the plan of selling stock below par.

As long as stock bears the dollar mark—it may be wise to remove the dollar mark entirely—it should mean something. It is pure misrepresentation to allow corporations to issue stock each share of which bears upon its face a certain value which is wholly fictitious and which has no relation whatever to the actual investment. People generally assume that $100 in stock represents an investment of $100, and if there were not this general supposition, which of course is often erroneous, there would not be the clamor that there is from certain quarters for permission to issue stock below par. As long as the dollar mark remains upon stock, let us be honest and straightforward and require that it shall be issued only for what it is supposed to represent.

It is impossible, in the few moments allotted to me, to discuss the sale of securities by public bidding. "Auction clauses", a phrase familiar to every gas man in Great Britain, have been in operation for more than a generation in many English cities. They work exceedingly well, and are so satisfactory that many corporations in Great Britain would strenuously oppose their repeal. Before one demands that the whole idea shall be thrown overboard simply because a few features adopted in Massachusetts have not proved satisfactory, he should carefully study English experience. In my opinion, certain changes ought to be made in the Massachusetts law, but to claim that the whole idea is wrong indicates that the

matter has not been carefully studied, and the experience of other countries and states where it has been tried has not been carefully investigated.

The argument is frequently made not only against the Massachusetts system, but against every form of public regulation and control, that it will drive out capital. It is undoubtedly true that whenever a state enacts laws which render it impossible for financial manipulation to continue that certain individuals who often control large sums of money will be forced to look elsewhere for a suitable field of operation. If this is an objection, the same argument could be urged against many meritorious measures. Laws against jerry-building, child labor, and piracy drive out capital and make certain occupations impossible, but no one seriously considers this fact as an argument against such laws. Piracy in corporation management is not only injurious to the individual but has imperilled the health of the state, and the loss of those individuals who promote such enterprises is a gain to a community.

Furthermore, when public service corporations are put upon a sound basis, investment capital will be attracted to them. Under the conditions that have existed in some states, the investor has been driven to other fields because of the improper methods that have been adopted. He will be induced to return when conditions are made stable and when it has become impossible for a corporation to be so manipulated as to deprive him of his investment or a fair return thereon. This is not theory alone, for the experience of England has clearly shown that, under public regulation and control, manipulation has ceased and securities of public service corporations have passed from the speculative to the investment class. Again, public regulation is spreading throughout the United States, and

as state after state enacts laws providing for stringent supervision of financial matters, the opportunity for the manipulator to follow his calling will be greatly reduced, and finally removed entirely. Capital will then go naturally where it is most certain of a fair profit.

E. D. DURAND: The Bureau of Corporations, with which I am connected, has not formulated any definite policy or views on the subject of capitalization.

The paper of Professor Bullock is particularly valuable as showing the difficulties which arise in any attempt to regulate capitalization. Those difficulties, moreover, are much greater when a state or the federal government seeks to introduce regulations where they have previously been absent. Massachusetts has had regulation continuously, and there has been less opportunity for vested rights to become established than elsewhere. Where corporations have been allowed to overcapitalize, and the earning power has been such as to cause the stock to sell at a price representing more than the actual investment, innocent purchasers at such higher price feel themselves wronged if, by any regulation of charges or prices or of capitalization, their stocks are reduced in value below the purchase price. While in the case of some public service corporations it might very properly be held by the general public that such investors took their own risk of regulation when they bought their stock, it is scarcely likely that the courts or legislatures will be disposed in general to disregard vested interests of this character, and any proposition to regulate prices and charges with sole reference to the actual investment is scarcely feasible from the political standpoint.

Difficulties with regard to capitalization are conspicuous in the case of such corporations, especially railroads,

as are likely to desire to combine with other corporations in the future. The adjustment of the capitalization in the case of such combinations, if such stringent rules as exist in Massachusetts are applied, can hardly be done without injustice. Take, for instance, a corporation which is undercapitalized, either in the sense that its capital is less than its actual investment or that it is less than the capitalization of its earning power at the normal rate. If such a corporation desires to combine with another which is not undercapitalized, or which is actually overcapitalized, the enforcement of the rule that the aggregate amount of the stock issued as the result of the combination shall not be greater than the amount previously outstanding will work a hardship. One suggestion which has been made to avoid this difficulty is that any undercapitalized corporation (even if the undercapitalization be merely with reference to earning power and market value of the stock and not to actual assets) should be permitted to issue additional stock, without additional investment within a certain time after the passage of the act regulating capitalization, so as to make the total stock of such corporation equal to its value as a going concern, thereby reducing the market price of the stock substantially to par. Such a permission would, of course, have to be restricted as to the time within which the additional stock should be issued, since otherwise, in the case of a corporation enjoying monopolistic profits, the increase in such profits after the passage of the law would become a basis for capitalization, which is precisely what is not desired. In other words, assuming that it is necessary to permit the capitalization of such vested interests as exist today, the law should so arrange as to prevent the future development of further vested interests and the capitalization of future increase in earning power.

W. Z. RIPLEY: While without doubt the restrictive policy of Massachusetts has many disadvantages, a comparison of the capitalization of its public service companies with those of other states affords clear evidence of the protection to investors and security for the public against overcapitalization. Some details in the law, such as the sale of stock at public auction, may properly be criticised. There is also little doubt that the law has been somewhat too strictly enforced. The obtaining of capital for development has been rendered somewhat too difficult. Yet, on the other hand, the principal difficulty under which companies like the Boston and Maine are at present suffering is of their own creation. Had the Boston and Maine Railroad properly withheld distribution of a part of its earnings in the form of dividends and reinvested them in the form of improvements and additions to their plant, the present crisis in its affairs need never have occurred. The recent liberalization of the Massachusetts statute is probably fitting and proper under the circumstances, but to reason that because a law has been somewhat too strict the principle of it is thereby wrongful, would be wide of the mark. On the whole, we are very much better off than are states like New York and New Jersey, where no limitation whatever is placed upon capital issues.

R. T. ELY: I think it would be well in this connection to say something about our Wisconsin practice. As you all know, the public utilities in Wisconsin are under the control of our railroad commission. So far as I can gather, our commission makes accuracy of measurements the first consideration. This was the first thing insisted upon when the Madison Gas and Electric Company's case was brought before the commission, on a petition for a reduc-

tion of rates. It was decided that meters and all measurements must be first of all scientifically accurate. The next step was to prescribe quality. I think, generally speaking, it would be held by the commission that quality of service must come before reductions in rates. There seems to be good reason for this order of procedure. We cannot tell what is a reasonable rate until we have accuracy of measurements and satisfactory quality. This would hold with regard to railway rates generally.

From the first, also, our Wisconsin commission attached great importance to physical valuation, for this is one measure of value and measure of value is a factor in determining reasonable rates. Physical valuation is one element only, but it certainly is one of very great importance. Valuations in Wisconsin are made by trained engineers, and so far as I know they have proceeded more thoroughly with us than anywhere else. The engineers are making mortality tables of various parts of utility plants, — boilers, for instance, — in order to determine proper depreciation.

After we have accuracy of measurements and service rendered, after we have satisfactory quality, after we have careful valuations, we are then in position to prescribe rates rationally and justly.

I should like to mention one other matter concerning corporation practice, as it has fallen under my observation as a director of one or two small corporations. I was once inclined to hold that in the case of all corporations, as of bank corporations, capital should be paid in full. My experience, however, has shown me that there is a strong ground for taking another position in the case of corporations of some kinds. One cannot always tell in advance how much capital will be needed to manage the corporation, and it is therefore wiser in such cases for only

a part of the capital to be paid in. There are frequent cases in Wisconsin where a third or one-half of the capital is paid in, but the stockholders may be called upon for the balance. This tends to the security of the corporation and to the protection of the stockholders. The arrangement in cases of this kind would frequently be not to call upon the stockholders for further subscriptions, though in an emergency they can be called on. This makes it possible to save property which might otherwise be lost to the stockholders. The practice as I have observed it is to issue at first stock only to the amount that is actually paid in. If the amount subscribed for is $10,000, and fifty per cent is paid in, the subscriber would receive stock for $5000. In such cases it would generally be the intention to issue the balance of the stock to him without further charge if the stock of the corporation should increase in value correspondingly. This is a frequent practice in the case of corporations dealing in real estate.

If it is clearly stated in such cases what is the amount actually paid in, there would seem to be very little objection to the practice, provided, also, that there is satisfactory scrutiny of the issue of new stock as stock dividends. In Wisconsin it is true there is no satisfactory scrutiny of the issue of new stock, not even in the case of public utility corporations and consequently there may be overcapitalization. Public opinion, however, in Wisconsin, as far as I have been able to observe, would not look with favor upon the issue of any stock which was not supposed to be represented by a corresponding value.

EDWARD W. BEMIS: The previous speaker has recommended the sliding scale in gas and the so-called Chicago plan in street railways. There is much to be said in favor

of the ultimate adoption of the sliding scale, but the fatal objection in the minds of many to its immediate adoption is this: companies would secure today too high a valuation of their capital, which would become the base line for estimating future dividends and prices. Public sentiment is so rapidly growing in favor of a lower value or entire neglect of franchise, good will, and going values that it will pay the public to delay entering into long contracts such as the sliding scale involves.

An equally serious objection to the Chicago plan, by which a company divides with the city a share of the profits rather than a reduction of fares, is that thus the street car riders are forced to pay part of the taxes. It is not an equitable system of taxation, although in some cases it may be the only practicable method.

It is not the fault of the Massachusetts commission in many cases that it has not reduced prices, for the law has contemplated that the initiative should be taken by patrons or consumers or by city officials. The commission at present is more vigorous than hitherto. There have been and perhaps still are three fundamental weaknesses in the Massachusetts theory of regulation:

1. An over emphasis upon capitalization as compared with regulation of price and service. The protection of the investor does not necessarily protect the consumer.

2. By dispensing with the so-called auction clauses that prevail in English gas companies and adopting a definite minimum price at which new stock may be sold to old stockholders, the state has, it is to be feared, given sacredness to the large earnings of the original stock. For example, on stock paying 10 per cent and may be selling at 200 the commission would allow a further issue at say 165. On this 6 per cent would be earned. Later the public, convinced that 10 per cent is too high a return on

four-fifths of the stock, seeks a lower price for light or street transportation, but this would reduce the return on the new stock so much below 6 per cent as to seem to some confiscatory. The consumer would be better off if the state had not gone further than the English auction clauses.

3. The Massachusetts commissions have been indifferent as to the magnitude of profits in the past, provided that all in excess of from 6 per cent to 10 per cent was invested in the plant. The theory was that the public would ultimately get the benefit. Court decisions now render this doubtful. The Masachusetts Lighting Commission is now beginning to demand a return to the people yearly in reduced prices of profits in excess of a reasonable amount.

The United States Supreme Court has before it in the Consolidated Gas case more important economic principles than it has faced since the Dred Scott case. What constitutes a proper valuation for purposes of rate making? Shall we include in physical value increased cost of land since purchased and the value of the paving laid by the city over the mains and conduits? Shall we allow any value to good will, going value, and franchises? The whole problem not only of regulation, but of public ownership, will rest in part on how these questions are ultimately settled. So far as the courts favor the companies in these matters, to that extent will public ownership be developed, for the latter never dreams of capitalizing the various values just referred to.

C. J. Bullock. There is no suggestion in my paper that the Massachusetts laws relating to the issue of securities should be repealed. I do, however, assert that it would be desirable to permit the issue of both stock and

bonds for less than par *under certain circumstances,* and subject to the approval and supervision of the proper commission. Mr. Maltbie's remark that an embarassed corporation should be immediately required to reorganize simply shows reckless disregard of the conditions under which Massachusetts public service corporations have been developed. Their securities represent cash invested at par, or at high premiums, in good faith; and to give such companies no option but immediate reorganization would be one of the most effectual methods that could be devised for discouraging investment in public service securities. Mr. Maltbie speaks as if an issue of stock at less than par gives certain stockholders a preference over others. As a matter of fact the law requires a *pro rata* distribution of new stock, and no possible preference can be thereby created. His statement that the laws have not restricted enterprise merely shows that he is totally unacquainted with the facts, and does not need serious consideration. It is enough to say that the situation in 1908, so far as railroads were concerned, had become so acute that the legislature without serious opposition made a radical change in the law. Professor Ripley admits that the laws have been too strict in some particulars, and that the amendment of 1908 was desirable. He intimates, however, that the difficulties in which the Boston and Maine Railroad was involved were due to the fact that the road had been paying excessive dividends, and he says that the embarassment might have been avoided if the company had withheld from the stockholders a part of the dividends paid them and invested it in improvements and additions to the plant. Such a course might have been easy and obvious if it had not been for difficulties created by the laws of the state. In the first place, much of the stock had been issued at such high prices as 160 or even

190, and the directors of the road were entirely justified in feeling that a dividend rate of 6 or 7 per cent, which amounted to less than half of that rate upon some of the shares, was not excessive. They were further aware of the requirement of our savings bank laws by which if the dividends should be reduced below 4 per cent the bonds of the company would cease to be a savings bank investment. Some critics of the railroad advocated reduction of dividends to 2 per cent, which would of course destroy the chief market for bonds. It is further to be considered that if the dividends had been cut to 4 per cent or less the stock would probably not have sold at par, and that under our public service laws the company would then have been unable to raise more capital by the issue of stock. It will be evident to anyone who considers these things that in endeavoring to pay dividends of 6 or 7 per cent the directors of the road were following the course that it was natural for them to take. Mr. Maltbie was good enough to intimate that my criticisms of the working of the auction requirement indicate that "the matter has not been carefully studied." I am quite content to leave the case as I stated it. The facts as given are not open to dispute, and the conclusions drawn from them seem amply warranted. My remarks did not relate to Massachusetts gas companies, which have not been so much embarassed by the auction laws. I am, indeed, of the opinion that it is possible for public service companies operating on a small scale and enjoying secure local monopolies, to raise capital in small amounts by selling securities in an auction room. For large enterprises, however, involving large issues of securities, such a method of sale seems to be the one best calculated to secure the lowest price; and I am constrained, therefore, to stand by all that I have said concerning the bad results

that have followed this provision of the Massachusetts law. In conclusion I may observe that general remarks about the desirability of public regulation, which was in no way called in question by my paper, but was expressly affirmed, will not help at all in rectifying the absurd mistakes made by Massachusetts or in enabling other states to avoid them.